SUPREME COURT, U. S.

FILED

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

Nos. 894

EDWARD H. WEITZEN, STANLEY R. GRANT, JACK J. FISCHER and BELOCK INSTRUMENT CORPORATION,

Petitioners,

—against—

CHARLES HEIT, WALTER V. TYMINSKI and MARVIN J. LEVY,

Respondents.

EDWARD H. WEITZEN, STANLEY R. GRANT, JACK J. FISCHER and BELOCK INSTRUMENT CORPORATION,

Petitioners,

—against—

BETTY VOLK, WALTER V. TYMINSKI and MARVIN J. LEVY,

Respondents.

STANLEY R. GRANT, LYBRAND, ROSS BROS. & MONTGOMERY, a partnership, CARL M. LOEB, RHOADES & CO., a partnership, and BELOCK INSTRUMENT CORPORATION,

Petitioners,

—against—

HELEN HOWARD and WALTER V. TYMINSKI,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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January 2, 1969

INDEX

PAGE

Opinions Below 2

Jurisdiction 2

Question Presented 3

Statute and Rule Involved 4

Statement of the Case 5

Reasons for Granting the Writ 11

Conclusion 19

Appendix

A. Opinion of Court of Appeals 1a

B. Opinion of District Court (Heit and Volk Cases) 1b

C. Opinion of District Court (Howard Case) 1c

Table of Authorities

Cases

Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951) 16

SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) 15, 16

SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) 2, 3, 7, 14, 15, 16, 19

PAGE

Statutes and Regulations

Securities Act of 1933,

Section 11, 15 U.S.C. § 77k 17

Section 12, 15 U.S.C. § 77l 17

Securities Exchange Act of 1934,

Section 9, 15 U.S.C. § 78i 17

Section 10(b), 15 U.S.C. § 78j 3, 4, 13, 14, 15, 16, 17

Section 18, 15 U.S.C. § 78r(a) 16, 17

Rule 10b-5, 17 C.F.R. § 240.10b-5 .....3, 4, 5, 9, 13, 16

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—against—

HELEN HOWARD and WALTER V. TYMINSKI,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners pray that a writ of certiorari issue to review judgments of the United States Court of Appeals entered in the above-entitled cases. The first two above-entitled

cases (hereinafter the "Heit" and "Volk" cases) were consolidated in the District Court, which entered a single judgment dismissing the consolidated complaint for legal insufficiency. The third above-entitled case (hereinafter the "Howard" case) was heard separately in the District Court and judgment was entered therein dismissing that complaint for legal insufficiency. The appeals taken from the two aforesaid judgments were consolidated and decided together in a single opinion rendered by the Court of Appeals on October 3, 1968. That opinion reversed the District Courts in view of the decision in *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), and remanded for further proceedings. Judge Moore dissented for the reasons set forth in his dissenting opinion in the *Texas Gulf Sulphur* case.

Opinions Below

The opinion of the Court of Appeals is not yet reported. It is printed as Appendix A hereto. The opinion of the District Court in the Heit and Volk cases is reported at 260 F.Supp. 598, and is printed as Appendix B hereto. The opinion of the District Court in the Howard case is reported at 262 F.Supp. 643, and is printed as Appendix C hereto.

Jurisdiction

The opinion of the Court of Appeals was rendered on October 3, 1968. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

Question Presented

Plaintiffs-respondents Heit, Volk and Howard were each purchasers of securities of defendant Belock Instrument Corporation ("Belock").* Their complaints allege that Belock's assets and earnings were overstated in various reports and financial statements issued by Belock prior to plaintiffs' dates of purchase, and that defendants (Belock, its directors, accountant and investment banker) knew or should have known of the alleged overstatements. Nowhere does any complaint allege that any defendant made or caused these statements to be made in connection with, or for the purpose of, effectuating any sales or purchases of securities by himself or anyone associated with him.

These actions thus present the question whether or not the allegation of a false or erroneous corporate statement will, standing alone without any alleged securities activity by the defendant corporation or its officers, directors, or other insiders, provide a foundation for an action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, to a plaintiff who subsequently buys that company's stock in the open market.

The Court of Appeals, noting that it was "presented with significant questions involving civil liability under Section 10(b) . . .", held (Judge Moore dissenting) that in light of the principles enunciated in the *Texas Gulf Sulphur* case, a 10(b) cause of action did exist.

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* On March 1, 1967 the name of petitioner Belock was changed to Applied Devices Corporation.

Statute and Rule Involved

Rule 10b-5 of the General Rules and Regulations promulgated by the Securities and Exchange Commission finds its statutory authorization in Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1964). The Section provides:

> "§78j. Manipulative and deceptive devices
>
> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> • • •
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5, promulgated under Section 10(b), in turn, provides:

> "§240.10b-5. Employment of manipulative and deceptive devices.
>
> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> "(a) To employ any device, scheme, or artifice to defraud,

"(b) To make any untrue statement of a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5.

Statement of the Case

Each of these actions arose out of widely publicized misfortunes of defendant Belock Instrument Corporation, a New York manufacturer of precision instruments and components. On June 18, 1965 prominent stories appeared in The New York Times and The Wall Street Journal reporting that Belock had issued a statement the previous day announcing that its auditors had "confirmed the existence of irregularities" concerning the distribution of its costs in Government contracts. The company had previously confirmed that it was under investigation by the Department of Justice. The following Tuesday, June 22, 1965, the Securities and Exchange Commission suspended trading in Belock securities.

On August 18, 1965 the Grand Jury in the Eastern District of New York returned a 41-count indictment ('65 Cr. 388, E.D.N.Y.) against Walter V. Tyminski, president of Belock; Jack Silverstein, its vice president and comptroller; and Marvin Joseph Levy, its vice president of operations, charging them with the presentation of false claims to the United States Government for labor, overhead and general and administrative expenses with respect to certain Armed Forces contracts. These officers, who were named as defen-

dants in these actions (in addition to the defendants-petitioners here) had previously been suspended from their duties by Belock's Board of Directors, and new management had been instituted. Defendant Silverstein subsequently entered a plea of guilty to one count. Thereafter, Tyminski and Levy were tried by a jury which convicted Tyminski on several counts and acquitted Levy.

The Institution of These Actions

On June 25, 1965 a class action was commenced by plaintiff Heit, who had allegedly purchased Belock convertible debentures one week earlier on June 18, 1965, the very day that confirmation of Belock's previously reported difficulties with the Government had been prominently reported in The New York Times and The Wall Street Journal. (Parenthetically, it should be mentioned that while this might have seemed an inauspicious time to purchase Belock securities plaintiff Heit's purchase, nevertheless, proved to be a fortunate one. The Belock debentures which he then bought at 90 traded as high as 550 during 1968).

On July 14, 1965 another class action was commenced by plaintiff Helen Howard. She had allegedly purchased a single Belock convertible debenture on June 16, 1965 at 111.

Finally, on July 28, 1965 a third class action was commenced—this one by plaintiff Betty Volk, who had allegedly purchased 100 shares of Belock common stock on April 22, 1965 and another 100 shares on April 27, 1965, both purchases being made at 5½ per share. (Belock common traded at up to 26½ during 1968).

The jurisdiction of the District Court in these actions was based upon the Securities Act of 1933, as amended, 15 U.S.C. § 77a *et seq.*, and the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78a *et seq.*

In September 1965, prior to answering, the various defendants who had been served moved, pursuant to Rule 12(b)(6), Federal Rules of Civil Procedure, to dismiss each of the above complaints on the grounds that they failed to state a claim upon which relief could be granted.

On November 24, 1965 Judge Cooper rendered an opinion dismissing the Howard complaint on the ground that it was "fatally defective" in failing to "show the gravamen of defendants' activities to be any wise 'in connection with the purchase or sale of any security' as those words have been construed in their statutory setting."

On June 9, 1966 Judge (now Chief Judge) Sugarman rendered an opinion granting defendants' motions to dismiss the Heit and Volk consolidated amended complaint for failure "to state a federal claim upon which relief can be granted." Plaintiffs' subsequent motion for reargument was denied.

Thereafter, appeals were taken from the final judgments entered pursuant to the opinions of the District Court. Those appeals were consolidated and argued on November 10, 1967. Noting that it had deferred decision until after the filing of the opinion in *SEC* v. *Texas Gulf Sulphur, supra,* the Court of Appeals rendered a decision on October 3, 1968 reversing and remanding for further proceedings.

The Complaints

As indicated above, the decisions rendered below relate to two complaints, the Heit and Volk consolidated amended complaint and the Howard complaint.

Although, as indicated below, there are minor differences in phraseology between the two complaints, they are sub-

stantially the same. The gravamen of each complaint is found in its assertions of misstatements of assets and earnings in Belock's public financial reports. According to the complaints, the figures in these reports incorporated and reflected the false charges which had been attributed to the Government contracts in issue and, as a result, overstated Belock's true assets and earnings.

The Defendants

As alleged in the complaints, defendant Belock Instrument Corporation is a New York corporation having its principal plant and offices in College Point, Queens. It is engaged in the manufacture and sale of precision instruments and components with more than 90% of its current sales derived from U.S. Government contracts with the Armed Forces. Its common stock and Series A debentures are listed on the American Stock Exchange.

As additional defendants, the Heit complaint named Walter V. Tyminski, Marvin J. Levy and Jack Silverstein (the former Belock officers who were indicted), identifying them only as Belock officers or directors, and Edward H. Weitzen, Jack J. Fischer and Stanley R. Grant, each of whom is identified only as a Belock director.

The Howard action named as defendants the same above-listed individual defendants (except for defendant Levy, who is omitted), identifying each of them as both officers and directors of Belock, with the exception of the defendant Stanley R. Grant, who is alleged to be a director not holding any office in the Company. In addition, the firm of Lybrand, Ross Bros. & Montgomery ("Lybrand"), alleged to be Belock's auditors, and the partnership of Carl M. Loeb, Rhoades & Co., alleged to own

substantial amounts of Belock stock, are also named as defendants.

The Alleged Wrongdoing

In both complaints the wrongdoing alleged is essentially the same.

The Heit and Volk complaint alleges that on or about February 4, 1965 Belock, at the direction of the individual defendants, filed with the SEC and the American Stock Exchange its Annual Report for the fiscal year ending October 31, 1964. Copies are also alleged to have been distributed to security holders, the press and the investment community.

Paraphrasing only pa.t of the language of Rule 10b-5, Belock's Annual Report to stockholders is alleged to have contained "statements which were materially false and misleading" and "untrue statements of material facts" in that the Report is claimed to have "substantially overstated Belock's net assets and past and prospective income." The Heit complaint then goes on to allege that similar false statements were made in other Belock reports, documents, press releases and reports to stockholders for the quarters ending April 30, 1964, July 31, 1964, October 31, 1964, January 31, 1965 and for the half-year ending October 31, 1964.

The Howard complaint does not specify particular reports or documents, or a given time period, but alleges financial figures and statements pertaining to Belock's 1963 and 1964 fiscal years as being included in the reports disseminated. Belock's reports are said to have contained "statements concerning [Belock's] net profits and income

and * * * underlying balance sheets for the periods concerned [which] were materially overstated, false and inaccurate. . . ."

Each complaint goes on to give the same explanation for the alleged misstatements. According to the Heit complaint, they "were based in large part upon substantial overcharges to the United States Government in connection with the contracts between Belock and the Government." According to plaintiff Howard, Belock's financial statements "failed to reflect improper distribution of costs and substantial overcharges in certain Government contracts which had a materially adverse effect on the financial condition of Belock as well as on its published prior earnings reports. . . ."

In each complaint it is alleged that the release of the financial statements in issue "was intended to and did have the effect of artificially inflating the market prices of Belock's securities," or "served to raise or prevent the market prices from declining of the securities of Belock Instrument during the periods involved." Plaintiffs Heit and Volk allege reliance upon Belock's statements. Plaintiff Howard merely alleges that by reason of the Belock statements, Belock securities "have been sold to and bought by plaintiff and the public at artificially inflated prices. . . ."

The Basis for Defendants' Liability

The only basis for the liability alleged against the defendants in the Heit complaint is the statement that the individual defendants had "knowledge or notice" that the reports in question were "false, misleading and contained untrue statements of material facts."

The Howard complaint, while making somewhat more elaborate allegations, comes down to the same basis for liability. It charges that "Belock Instrument and the individual defendants caused or permitted such improper distribution of costs and overcharges or negligently failed to supervise the record and bookkeeping activities of Belock Instrument personnel." It is alleged that defendants "had or were charged with knowledge of the facts" and that "defendants owed plaintiff and all members of the class the duty of using reasonable care in the preparation and dissemination of the figures and forecasts • • • referred to."

Most significant is the total absence from either complaint of any allegation that any defendant made or caused the alleged misstatements to be made in connection with or for the purpose of effecting any sales of securities by him, by any persons associated with him, or by Belock.

Reasons for Granting the Writ

I.

These cases involve an issue of fundamental importance under the Federal Securities Acts.

The Problem Presented

Any significant misconduct (or unrecorded negligence) by a corporation, or its officers or agents, is bound to have some effect upon the corporation's financial and overall business picture. As a result, that corporation's financial statements and corporate reports will be inaccurate or incomplete to the extent that they fail to disclose or take account of that misconduct (or negligence).

If, for example, a corporate officer, unbeknownst to anyone, embezzles large sums from the corporate till, any balance sheet issued by the corporation prior to discovery of the embezzlement will contain a false statement of the corporation's assets.

Again, to pose another example, if a corporation has been guilty over a period of time of violations of the antitrust laws to the injury of third parties, any corporate report or financial prediction issued during that time by the corporation which fails to disclose that the company has potential treble-damage liabilities arising out of its antitrust violations may be said to omit to state a material fact concerning the corporation, or to misrepresent its actual liabilities or the company's financial condition.* If the corporation were held liable to anyone and everyone who purchased its securities during such period of time (which might have extended over many years) from third parties in the open market, the cost to one corporation could be astronomical and would, of course, bear no relationship to any securities transaction by the corporation.

The same will, of course, be true of any of the traditional varieties of unreported corporate misconduct or negligence underlying most stockholder derivative actions, such as insider dealings with the corporation, diversion of

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* A dividing line between affirmative misrepresentation and omission will seldom, if ever, exist in situations where corporate financial statements fail to take alleged wrongdoing into account. The pleader can allege either a failure to disclose the wrongdoing, or misrepresentation in the company's financials because they fail to reflect the wrongdoing, or both. Here, for example, the Howard complaint alleges that Belock's financials "were materially overstated, false and inaccurate in that they failed to reflect improper distribution of costs and substantial overcharges in certain government contracts. . . ."

assets or misappropriations of corporate opportunities. Unless these are revealed in the company's reports, it may well be said that these reports contain untrue statements or omissions.

In each of the hypothetical situations described above, a purchaser or seller of the company's securities can plead, as in the case of Belock, that he sold or purchased in reliance upon the accuracy and completeness of the corporate reports, or at market prices which reflected the financial and business conditions of the company set forth in its reports.

The question presented here is whether or not the above kind of corporate misconduct, with its inevitable resultant effect upon the company's financial and other reports, can be deemed a "manipulative or deceptive device or contrivance" which is "use[d] or employ[ed], in connection with the purchase or sale of any security," within the language of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 when, as here:

> (a) neither the underlying misconduct nor the resultant misstatement or omission in the corporate report is alleged to have been effectuated with the intention, desire, or for the purpose, of inducing purchases or sales of the corporate securities, and plaintiffs themselves concede their inability to allege that defendants had any "motive or desire to inflate the market price" (Appellants' Brief in the Court of Appeals, pp. 33-34).
>
> (b) none of the defendants, nor anyone associated with any defendant, is alleged to have bought or sold any securities from or to anyone, or to have participated in any kind of securities transactions whatever.

Petitioners submit that to create a 10(b) cause of action premised upon such allegations (as the Court of Appeals did here) would effectively amend the statutory prohibition against any fraud "in connection with the purchase or sale of any security" so as to encompass any misconduct (or unrecorded negligence) in connection with any corporation whose securities are publicly held.

The Decision Below

The result reached here by the Court of Appeals was, as previously noted, based entirely upon the decision in *SEC* v. *Texas Gulf Sulphur Co., supra.* After reviewing the decisions rendered here by the District Courts, Judge Medina stated:

> "However, we must now reassess the holdings below in light of the principles enunciated in *SEC* v. *Texas Gulf Sulphur Co.*, Docket No. 30882 (2d Cir. *in banc* 1968) (Slip Sheet at 3587). Judge Waterman writing for the Court in *Texas Gulf Sulphur* construed the 'in connection with' requirement broadly and held that the clause was satisfied whenever a device was employed 'of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities,' *SEC* v. *Texas Gulf Sulphur Co.*, Slip Sheet at 3630. There is no necessity for contemporaneous trading in securities by insiders or by the corporation itself. 'Rule 10b-5 is violated whenever assertions are made * * * in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media * * * , if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes.' *SEC* v. *Texas Gulf Sulphur Co.*, Slip Sheet at 3634.

> "Applying this rule, and accepting at face value plaintiffs' well pleaded allegations, as we must on a motion to dismiss for failure to state a claim, we conclude that plaintiffs have met the requirements of the 'in connection with' clause."

The above-quoted holding in *Texas Gulf Sulphur* arose from that company's April 12, 1964 press release commenting upon rumors concerning its Timmons, Ontario mineral discovery. That press release both followed upon and preceded substantial insider trading in Texas Gulf Sulphur securities, although the company itself was not a purchaser or seller of securities.

Here, in contrast to *Texas Gulf Sulphur,* there is no charge whatever of any participation by the corporation or any insider in any transaction in Belock securities. The issue of whether or not a corporate misstatement or omission, in and of itself, gives rise to a 10(b) cause of action is clearly presented. Here, too, the question is presented in the context of an action at law for damages—not one solely for equitable or prophylactic relief, as in *Texas Gulf Sulphur.**

The Error Below

Judge Leonard Moore, who was a member of the panel here as well as in the *Texas Gulf Sulphur* case, has written a thorough dissent to the *Texas Gulf Sulphur* opinion including, in the portion dealing with the Texas Gulf Sulphur press release, many of the points and authorities advanced by the defendants in the appeals of these cases. In his dis-

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* This Court has recognized that "It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages." *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193 (1963).

senting opinion here he incorporates by reference his *Texas Gulf Sulphur* dissent. Petitioners rely upon that portion of Judge Moore's *Texas Gulf Sulphur* opinion dealing with the press release and make no attempt to repeat the arguments and discussion set forth therein.

Suffice it to say, as Judge Moore points out, prior authorities under 10(b) had been founded upon some element of participation by a defendant in a securities transaction. Thus, *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), concerned a financial advisor who sold securities after its favorable recommendations had caused the market price to rise. In another leading case, *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951), the defendants, according to the complaint, had engaged in fraudulent conduct in connection with their sales of preferred stock. The Court held that other securities purchasers, *i.e.*, purchasers of common stock who had been injured by that fraud had standing to sue despite the absence of privity. Other prior cases are in the same vein.

The Federal Securities Act Would Be Effectively Recast

A direct result of the novel interpretation of Section 10(b) and Rule 10b-5 adopted here and in the *Texas Gulf Sulphur* case is that it completely undercuts the comprehensive scheme of regulation set forth in the Securities Acts. This is strikingly indicated by looking at Section 18 of the 1934 Act, 15 U.S.C. 78r(a). Plaintiffs here had sued under that Section as well as under 10(b) and the Court of Appeals, in Part II of its opinion, considered in detail whether or not a cause of action under Section 18 existed, remanding for further proceedings on that point.

Yet, there is no need or occasion for these plaintiffs or any other plaintiffs ever again to resort to Section 18—given the interpretation of 10(b) just adopted. If a corporation has issued any statement which can be alleged to be false or misleading, a 10(b) cause is made out, avoiding all of the substantive and procedural limitations of Section 18. The same would be true as to actions brought under Section 9 of the 1934 Act or Sections 11 or 12 of the 1933 Act—or any other sections of the various Securities Acts upon which private causes of action may be founded.

Thus, the practical result of the holding below would be to cast into discard all sections of the Securities Acts other than 10(b) and to make that Section the basis henceforth for all actions under the Federal securities laws—and, at the same time, to expand the Federal securities laws to cover virtually every sort of corporate misconduct.

Corporate Officers and Directors Would Be Subjected to Incalculable Claims for Damages

As previously noted, any significant corporate misconduct affects the corporate financial picture. With the modern, publicly-held corporation, which is constantly, and of necessity, publishing reports and financial statements, it is possible in virtually every case of corporate misconduct to point to some document issued by the corporation which was inaccurate, misleading or which contained omissions. To hold that this fact, standing alone, makes the misconduct one "in connection with the purchase or sale of any security" would turn every action for corporate misconduct into a federal securities fraud case.

In addition to providing a federal forum for virtually every case of corporate wrongdoing, the result reached

here would also subject corporate officers and directors to damage claims of incalculable amount brought by securities traders.

Thus, the vagaries of the securities market are such that revelation that the president of a corporation has stolen $1,000,000 from the corporation and fled to Brazil may send the market tumbling by tens of millions of dollars. To allow purchasers of stock to recover from the corporation or its officers, directors or accountants the amount the market has dropped—on the theory that the corporate reports failed to reflect the embezzlement due to the negligence or with the imputed knowledge of such persons—would result in judgments against such parties out of all rational proportion to whatever responsibility, if any, for the misdeeds or oversights may be theirs.

Indeed, if we take the case of some large publicly-held corporations, and pose hypothetical examples of wrongdoing for which their officers, directors and accountants might be held responsible under the theories of the complaints here, it is not hard to visualize situations where, as a result of some corporate wrongdoing not revealed in the corporate reports, market prices of securities might fall by billions of dollars, and purchasers of securities would—on Respondents' theories—be entitled to judgments in like amount against the directors, officers and accountants.

We have only to look at recent experience in the electrical equipment industry to find a situation where for many years certain conduct in violation of the antitrust laws was occurring which was undoubtedly not adverted to in corporate reports. Revelation of the extent of these violations and the consequences thereof to the corpora-

tions concerned had a most detrimental effect on the market prices for the securities of these companies. Under the Court of Appeals' theory, any person who purchased stock in these companies at a time when the antitrust violations were not known could bring a federal securities fraud case against the officers and directors, charging them with issuing false corporate reports which failed to take account of the antitrust violations and the corporations' potential liabilities flowing therefrom.

The fact that, so far as research can reveal, such actions as indicated in the above examples have not until now been even attempted demonstrates vividly the unique and unprecedented theory of law being adopted here and in the *Texas Gulf Sulphur* case.

CONCLUSION

The writ of certiorari should issue.

Respectfully submitted,

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January 2, 1969

APPENDIX "A"

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 162 and 163—September Term, 1967.

(Argued November 10, 1967 Decided October 3, 1968.)

Docket Nos. 30410 and 31157

CHARLES HAFT,

Plaintiff-Appellant,

—against—

EDWARD H. WEITZEN, [illegible], STANLEY R. GRANT, MARVIN J. LEVY, JACK J. FISCHER and BELOCK INSTRUMENT CORPORATION,

Defendants-Appellees,

and

JACK SILVERSTEIN,

Defendant.

BETTY VOLK,

Plaintiff-Appellant,

—against—

EDWARD H. WEITZEN, WALTER V. TYZINSKI, STANLEY R. GRANT, MARVIN J. LEVY, JACK J. FISCHER and BELOCK INSTRUMENT CORPORATION,

Defendants-Appellees,

and

JACK SILVERSTEIN,

Defendant.

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January 2, 1969

APPENDICES

APPENDIX "A"

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 162 and 163—September Term, 1967.

(Argued November 10, 1967 Decided October 3, 1968.)

Docket Nos. 30410 and 31157

CHARLES HEIT,

Plaintiff-Appellant,

—against—

EDWARD H. WEITZEN, WALTER V. TYMINSKI, STANLEY R. GRANT, MARVIN J. LEVY, JACK J. FISCHER and BELOCK INSTRUMENT CORPORATION,

Defendants-Appellees,

and

JACK SILVERSTEIN,

Defendant.

BETTY VOLK,

Plaintiff-Appellant,

—against—

EDWARD H. WEITZEN, WALTER V. TYMINSKI, STANLEY R. GRANT, MARVIN J. LEVY, JACK J. FISCHER and BELOCK INSTRUMENT CORPORATION,

Defendants-Appellees,

and

JACK SILVERSTEIN,

Defendant.

HELEN HOWARD,

Plaintiff-Appellant,

—against—

STANLEY R. GRANT, WALTER V. TYMINSKI, LYBRAND, ROSS BROS. & MONTGOMERY, a partnership, CARL M. LOEB, RHOADES & Co., a partnership, and BELOCK INSTRUMENT CORPORATION,

Defendants-Appellees,

and

LAWRENCE J. LEVINE, JACK SILVERSTEIN, EDWARD H. WEITZEN, JOHN F. DONATO, JACK J. FISCHER, CHARLES WELTHY & HARRY AHRENS, as Executors of the Estate of HELEN NEUSCHAFER, deceased,

Defendants.

Before:

MEDINA, MOORE and HAYS,

Circuit Judges.

MEDINA, *Circuit Judge*:

On this appeal from two judgments dismissing plaintiffs' complaints, we are presented with significant questions involving civil liability under Sections 10(b) and 18(a) of the Securities Exchange Act of 1934. Because the principal questions involved on these appeals have been under consideration by the active judges of this Court sitting *in banc* we have deferred decision until after the filing of the opinions in *SEC* v. *Texas Gulf Sulphur Co.*, Docket No. 30882, on August 13, 1968.

There are three separate actions before us now, *Heit* v. *Weitzen, et al.*, and *Volk* v. *Weitzen, et al.*, originally con-

solidated by the District Court, and *Howard* v. *Grant, et al.*, consolidated on appeal by this Court with *Heit* and *Volk*. The various complaints involve essentially the same operative facts as they all are based on the fact that Belock Instrument Corporation allegedly failed to disclose that a substantial amount of its income for the fiscal year 1964 was derived from various overcharges on government contracts. Thus, the consolidated amended complaint in *Heit* and *Volk* alleges that Heit on June 18, 1965 purchased $5,000 principal face amount of Belock's 6% convertible subordinated debentures at a price of 90% of face amount in reliance on various "materially false, misleading and untrue statements of Belock's net assets and past and prospective income," contained in Belock's Annual Report, and press releases, as well as documents filed by the individual defendants with the SEC and the American Stock Exchange. Volk allegedly purchased 100 shares of Belock common stock on April 22, 1965 and another 100 shares on April 27, 1965 in reliance on these same false statements. Heit and Volk seek to represent both themselves and the entire class of persons who purchased either common stock or debentures between April 30, 1964 and June 21, 1965, and who have either sold or continue to hold these investments at a loss. It is further alleged that the dissemination by defendants of these false statements had the effect of artificially inflating the market price of Belock's common stock and debentures and that defendants had knowledge or notice of the falsity of the statements. In addition to Belock Corporation, the individual defendants served in *Heit* and *Volk* include Weitzen, Tyminski, Fischer, and Grant, all directors of Belock Corporation, and Levy who was a vice president of the corporation.

In the *Howard* complaint it is alleged that plaintiff Helen Howard purchased a 6% convertible subordinated Belock Corporation debenture on June 16, 1965 at an artificially inflated price. The price inflation was allegedly caused by the circulation and dissemination by the defendants "through press statements to the investment community * * * of statements as to the purported earnings and income of Belock Instrument and forecasts with respect thereto which in fact were gross overstatements." Howard seeks to represent the entire class composed of persons who purchased Belock stock or debentures in the open market and who were either misled by the published false material or by the artificially inflated market price. The defendants in *Howard* who were served include, in addition to Belock Corporation, Tyminski and Grant, Carl M. Loeb, Rhoades & Co., who is Belock's controlling shareholder, and Lybrand, Ross Bros. & Montgomery, Belock's auditors.

In *Howard,* Judge Cooper granted defendants' motion to dismiss for failure to state a claim upon which relief could be granted, primarily because the alleged fraud did not occur "in connection with the purchase or sale of any security" as required by Rule 10b-5. *Howard* v. *Levine,* 262 F. Supp. 643 (S. D. N. Y. 1965). Judge Sugarman, relying in part on Judge Cooper's opinion, similarly dismissed the Section 10b claims in *Heit* and *Volk* for failure to satisfy the "in connection with" clause. *Heit* v. *Weitzen,* 260 F. Supp. 598 (S. D. N. Y. 1966). Judge Sugarman also found that plaintiffs had failed to state a claim for relief under Section 18 of the 1934 Act since none of the reports upon which the claims were predicated were "filed" with the SEC as required by that Section. The motions to dismiss were granted without leave to replead. We also note that defen-

dants in all the actions have previously moved for summary judgment based on the fact that plaintiffs have suffered no damage since after the institution of these actions the price of both Belock's common stock and debentures has risen above the prices originally paid by plaintiffs. Neither of the judges below reached this question, nor do we.

I.

Rule 10b-5, 17 C. F. R. Section 240.10b-5, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.[1]

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[1] The SEC in enacting Rule 10b-5 acted pursuant to the authority given it by virtue of Section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. Section 78j(b). That section provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate com-

Each of the judges below referred to the fact that the basic fraudulent scheme alleged in the complaints was primarily directed toward the government "notwithstanding its possible incidental market impact." Thus, it was held that the concealment of the overcharges when the financial statements were released was for "the purpose of further defrauding the Government by not disclosing the original malfeasance and not for the purpose of perpetrating a 'misrepresentation or fraudulent practice usually associated with the sale or purchase of securities.'" *Heit* v. *Weitzen*, 260 F. Supp. 598, 602 (S. D. N. Y. 1966). Furthermore, as stated by Judge Cooper, since neither the corporate nor the individual defendants in the instant action were engaged in purchasing or selling Belock securities, he could see no basis for a finding that the alleged fraud occurred "in connection with the purchase or sale of any security."

However, we must now reassess the holdings below in light of the principles enunciated in *SEC* v. *Texas Gulf Sulphur Co.*, Docket No. 30882 (2d Circuit *in banc* 1968) (Slip Sheet at 3587). Judge Waterman writing for the Court in *Texas Gulf Sulphur* construed the "in connection with" requirement broadly and held that the clause was satisfied whenever a device was employed "of a sort that

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merce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities," *SEC* v. *Texas Gulf Sulphur Co.*, Slip Sheet at 3630. There is no necessity for contemporaneous trading in securities by insiders or by the corporation itself. "Rule 10b-5 is violated whenever assertions are made * * * in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media * * * , if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes." *SEC* v. *Texas Gulf Sulphur Co.*, Slip Sheet at 3634.

Applying this rule, and accepting at face value plaintiffs' well pleaded allegations, as we must on a motion to dismiss for failure to state a claim, we conclude that plaintiffs have met the requirements of the "in connection with" clause. It is reasonable to assume that investors may very well rely on the material contained in false corporate financial statements which have been disseminated in the market place, and in so relying may subsequently purchase securities of the corporation. The "ulterior motive" present in the instant case—the concealment of the fraud from the government—is irrelevant, since the false information was circulated to a large segment of the investing public. It is impossible to isolate the particular "fraudulent" acts and consider them as directed toward the government alone.

As the "in connection with" clause has been satisfied, we must now deal with the question of the standard by which the conduct of the defendants is to be judged. Judge Waterman in the *Texas Gulf Sulphur* opinion held that proof of negligence was sufficient to sustain an action for

injunctive relief under Rule 10b-5(2), but at the same time found it not necessary to decide whether negligence absent a showing of bad faith would suffice in a private suit for damages. *SEC* v. *Texas Gulf Sulphur Co.*, Slip Sheet at 3637. However, no question of liability for damages was before the Court in *Texas Gulf Sulphur* and Judge Friendly, in a concurring opinion joined in part by other judges, intimated that the appropriate standard in a private damage action should embody a scienter requirement. *SEC* v. *Texas Gulf Sulphur Co., supra,* Slip Sheet at 3646-47. The question is troublesome. Compare *Weber* v. *C. M. P. Corp.*, 242 F. Supp. 321 (S. D. N. Y. 1965) with *Royal Air Properties, Inc.* v. *Smith,* 312 F. 2d 210 (9th Cir. 1962). See also III Loss, Securities Regulation at 1785.

There is no occasion for us to enter this thicket now as we pass only upon the legal sufficiency of the complaints to allege a claim for relief. This each of the complaints fairly does. The charge that defendants "knew or should have known" adequately alleges actual knowledge of the falsity of the statements, and, alternatively, negligence or lack of diligence in failing to ascertain the true facts. If some form of scienter test is to be applied, as Judge Friendly seems to suggest in his concurring opinion in *Texas Gulf Sulphur,* we think the alternative allegation of actual knowledge of falsity is amply sufficient as a matter of pleading. And this would seem to be so whether the scienter test ultimately applied be strict or liberal.[2] See

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[2] The consolidated amended complaint in *Heit* and *Volk*:

Paragraph 7: The individual defendants had knowledge or notice that the reports, statements and documents referred to in paragraphs 5 and 6 above were false, misleading and con-

Fed. R. Civ. P. 8(e)(2); *Pettit* v. *American Stock Exchange*, 217 F. Supp. 21, 28-29 (S. D. N. Y. 1963); *Michael* v. *Clark Equipment Co. et al.*, 380 F. 2d 351, 352 (2d Cir. 1967).

Therefore, as far as the claims under Rule 10b-5 are concerned we reverse the judgments appealed from and hold that each of the complaints is sufficient to withstand a motion to dismiss for failure to state a claim for relief.

II.

Section 18(a) of the 1934 Act, 15 U. S. C. Section 78r(a) provides:

> Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not know-

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tained untrue statements of material facts, as hereinbefore alleged.

The complaint in *Howard*:

Paragraph 13: Belock Instrument and the individual defendants caused or permitted such improper distribution of costs and overcharges or negligently failed to supervise the record and bookkeeping activities of Belock Instrument personnel with respect to such government contracts.

Paragraph 14: The statements above alleged appeared on balance sheets and profit and loss statements referred to in paragraph 12 hereof which were examined or certified, or both, by defendant Lybrand, Ross, which knew or should have known that such balance sheets and profit and loss statements examined or certified by it were incorrect and false and misleading.

> ing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant.

Plaintiffs in *Heit* and *Volk* have contended that they relied on various documents which were "filed" within the meaning of Section 18. The documents in question are the "10K report" for the fiscal year ended October 31, 1964[3] and Belock's annual report for the same year, which was filed with the American Stock Exchange.

Judge Sugarman correctly ruled that the copies of the annual report submitted to the SEC were not "filed" docu-

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[3] The "10K" report is a detailed document, similar to an annual report, which must be filed annually by all issuers of securities registered pursuant to Section 12 of the Securities Exchange Act of 1934 and by all registrants under the Securities Act of 1933 which are subject to Section 15d of the Securities Exchange Act. Rule 13a-1, 17 C. F. R. Section 240.13a-1; Rule 15d-1, 17 C. F. R. Section 240.15d-1. The SEC has issued specific instructions outlining the material which must be contained in the "10K" report. When the "10K" report is filed with the SEC additional supplemental information must also accompany the report. This supplemental information consists of any annual report for the registrant's last fiscal year and every form of proxy soliciting material sent to more than ten of the registrant's stockholders with respect to any annual or other meeting of stockholders. 17 C. F. R. Section 249.310. See also footnote 4 *infra* at p. 12a.

ments within the meaning of Section 18. Rule 14a-3(c), 17 C. F. R. Section 240.14a-3(c), of the Regulations under the Securities Exchange Act of 1934, as it read when the 1964 financial statements were issued on or about February 4, 1965 provided:

> Four copies of each annual report sent to security holders pursuant to this section shall be mailed to the Commission * * * . The annual report is not deemed to be "soliciting material" or to be "filed" with the Commission or subject to this regulation otherwise than as provided in this section, or to the liabilities of section 18 of the Act, except to the extent that the issuer specifically requests that it be treated as a part of the proxy soliciting material or incorporates it in the proxy statement by reference.

The above exemption provision, in addition to exempting the annual report filed with the SEC from the status of a "filed" document, also exempts the annual report filed with the American Stock Exchange from the coverage of Section 18. This result is required by the specific language of the second sentence of the above provision which contains several independent exemption clauses. Thus, the annual report is neither considered to be "filed with the Commission" nor subject to "the liabilities of section 18 of the Act." The latter phrase covers the alleged filing with the American Stock Exchange.

Although *Fischman* v. *Raytheon,* 188 F. 2d 783 (2d Cir. 1951) held that Section 18(a) applied to "documents" filed with a national securities exchange, the effect of the above regulation is to withdraw annual reports from the category of "filed" documents. The SEC has the power to prescribe rules that "may be necessary for the execution of the

functions vested in" it by the Securities Exchange Act, Section 23(a) Securities Exchange Act of 1934, 15 U. S. C. Section 78w(a), and in the performance of this duty the Commission may properly determine which filings are to be deemed "filings" for the purposes of Section 18.

Therefore, the only possible "filed" document remaining is the "10K report" which is submitted to the SEC.[4] We think it clear that the 10K report is a "filed" document within the meaning of Section 18.[5] See *Fischer* v. *Kletz,* 266 F. Supp. 180 (S. D. N. Y. 1967). The exemption provision contained in the SEC regulations relating to filing of the 10K report applies only to the copies of the annual report which accompany the 10K report and not the 10K report itself. Regulation 249.310 as it read when the Belock 10K report was allegedly filed provided:

> (i) Every registrant which files an annual report on this form [10K] shall furnish to the Commission for its information four copies of the following * * *

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[4] SEC Regulations Section 249.310

> (b) General Instructions—(1) Rule as to use of Form 10-K. Form 10-K shall be used for annual reports pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934, for which no other form is prescribed.

Section 13 of the Securities Exchange Act of 1934, 15 U. S. C. Section 78m

> (a) Every issuer of a security registered pursuant to Section 12 of this title shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security * * *
>
> (2) such annual reports (and such copies thereof), certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports (and such copies thereof), as the Commission may prescribe.

[5] Defendants have conceded this point in their brief.

(a) any annual report to stockholders covering the registrant's last fiscal year;

* * * * *

(ii) The foregoing material shall not be deemed to be "filed" with the Commission or otherwise subject to the liabilities of Section 18 of the Act, except to the extent that the registrant specifically requests that it be treated as a part of its annual report on this form [10K] or incorporates it therein by reference.

The opinion of the District Court is unclear and we are unable to determine whether Judge Sugarman intended to hold that the 10K report was not a "filed" document. Appellees contend that Judge Sugarman ignored plaintiffs' claims based on form 10K simply because on oral argument appellants conceded that they could not allege or prove actual knowledge of and reliance upon any Belock 10K report. Appellants have denied making this concession. Reliance on the actual 10K report is an essential prerequisite for a Section 18 action and constructive reliance is not sufficient.[6] Therefore, although under the liberal pleading provisions of the Federal Rules of Civil Procedure, the *Heit* and *Volk* complaints might well be considered broad enough to cover the allegation that they

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[6] This is made clear by comparing Section 18 with Section 11 of the Securities Act of 1933. Section 11 contains a provision enabling a plaintiff to establish reliance "without proof of the reading" of the particular document. See III Loss, Securities Regulation, p. 1752 (2d Ed. 1961). See also Comment, Civil Liability for Misstatements in Documents Filed Under Securities Act and Securities Exchange Act, 44 Yale L. J. 456, 460-61 (1935); Note, Accountants Liabilities for False and Misleading Financial Statements, 67 Colum. L. Rev. 1437, 1445 (1967).

relied on misrepresentations contained in 10K reports,[7] we believe it advisable to remand these cases to the District Court for a reconsideration of the question of leave to amend. Judge Sugarman may have relied on plaintiffs' alleged concession or he may have thought that the complaint was not broad enough to cover an allegation of reliance on a 10K report. On the other hand, he may have incorrectly assumed that a 10K report could not form the basis for a Section 18 action. Thus the interests of justice would seem to require a clear appraisal of the pros and cons.

Finally, although the complaint in *Howard* contains no Section 18 claim for relief, it is stated in appellants' brief that such allegations will be added to the *Howard* complaint "if leave to amend is granted." We leave this for the consideration of the District Court if, as and when such an application for leave to amend is addressed to that Court.

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[7] *Heit-Volk* consolidated amended complaint.

Paragraph 5(a): On or about February 4, 1965, Belock, at the direction of the individual defendants, caused to be filed with the Securities and Exchange Commission ("SEC"), pursuant to the provisions of the Securities Exchange Act of 1934 and the General Rules and Regulations promulgated thereunder, and with the American Stock Exchange, its Annual Report for the fiscal year ended October 31, 1964.

Paragraph 6: Similar materially false, misleading and untrue statements of Belock's net assets and past and prospective income were contained in reports and other documents filed by Belock at the direction of the individual defendants with the SEC and the American Stock Exchange, as well as in press releases and reports to stockholders for the quarters ending April 30, 1964, July 31, 1964, October 31, 1964, January 31, 1965, and for the half-year ending October 31, 1964, issued by Belock at the direction of the individual defendants.

Paragraph 11(a): Plaintiffs purchased and retained Belock's securities and reliance on the truth of the statements and representations herein alleged.

III.

The District Court did not rule on defendants' motions for summary judgment. We believe it would be inappropriate at this early stage in the proceedings to deal with the issue of damages raised by these motions. We agree with the SEC that questions relating to damages should be postponed until after the facts have been fully developed at the trial.[8]

We wish to express our thanks to the SEC for submitting an *amicus curiae* brief at our request in this case.

Reversed and remanded for further proceedings consistent with this opinion.

MOORE, *Circuit Judge* (dissenting):

For the reasons set forth in my dissenting opinion in *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co., et al.*, —— F. 2d —— (Slip Opinion, pp. 3676-3690), I would hold that the "in connection with the purchase or sale of any security" requirement of Rule 10b-5 has not been met in the complaints dismissed below. Therefore, I would affirm the decisions of Judges Sugarman and Cooper. Apparently, the propriety of these suits as appro-

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[8] SEC *Amicus Curiae* Brief at p. 32.

> [The determination of this issue] should properly await the trial of the case, which will provide a complete record as to exactly what the defendants did, why they did it and how this affected the plaintiffs. We believe the Court will then be in a better position to examine and resolve questions with respect to the appropriate remedy, giving consideration to how a damage award against the issuer would affect the issuer and all of its stockholders, including those who neither bought nor sold. In so doing the Court will be able to utilize its traditional flexibility with respect to remedies, avoiding, on the one hand, Draconian relief and, on the other hand, an opportunity for violators to profit from their wrongdoing.

priate class actions has not been presently challenged and is not before us. In any event, even if proper, resolution of any and all issues relating thereto would be for the trial. The Heit and Volk consolidated amended complaint alleges that plaintiff Heit "brings this action on his own behalf and on behalf of all other persons who purchased Belock's debentures between April 30, 1964 and June 21, 1965, and who have either sold or continue to hold such debentures at a loss." The allegation as to Volk is identical except that it relates to common stock. Obviously, such a class, which plaintiffs claim to champion, would be wholly unrelated to any of the facts as pleaded. Belock was engaged principally in engineering and manufacturing military electronic equipment. The price range of Belock's 6% convertible debentures in 1964 was 178 high and 97½ low and in the first six months of 1965, 149 high and 75 low; for the common stock the range was 1964 high 5⅜, low 3⅝, and for the first six months of 1965, 5⅞ high, 2⅝ low. The causes for the wide fluctuations of the thousands of listed securities would be legion even if ascertainable and cover events from the national and international to ever-changing local situations in specific companies. A class for purposes of a lawsuit could scarcely consist of all persons who bought stock on one of the national exchanges and subsequently sold it at a loss. To be sure, plaintiffs qualify this claim by alleging that "The other members of the stock class and the debenture class purchased and retained Belock's securities in reliance on the truth of the statements and representations herein alleged." Cons. Am'd Compl. ¶11(b). Thus, limited to "reliance," possibly a "class" is stated. As previously stated, this determination, together with damages, if any, must await a trial. The same infirmities as to "class" exist in my opinion in the Howard complaint to an even greater extent because the limitation is less specific.

APPENDIX "B"

UNITED STATES DISTRICT COURT

FOR THE SOUTHERN DISTRICT OF NEW YORK

No. 65 Civ. 1942

June 10, 1966

CHARLES HEIT,

Plaintiff,

—against—

EDWARD H. WEITZEN, WALTER V. TYMINSKI, JACK SILVERSTEIN, STANLEY R. GRANT, MARVIN J. LEVY, JACK J. FISCHER and BELOCK INSTRUMENT CORPORATION,

Defendants.

BETTY VOLK,

Plaintiff,

—against—

EDWARD H. WEITZEN, WALTER V. TYMINSKI, JACK SILVERSTEIN, STANLEY R. GRANT, MARVIN J. LEVY, JACK J. FISCHER and BELOCK INSTRUMENT CORPORATION,

Defendants.

SUGARMAN, District Judge.

Charles Heit (Heit) as plaintiff in 65 Civil 1942 and Betty Volk (Volk) as plaintiff in 65 Civil 2303 each commenced an action against defendants Weitzen, Tyminski, Silver-

stein, Grant, Levy, Fischer and Belock Instrument Corporation (Belock), seeking damages alleged to have been sustained by each plaintiff in purchasing securities of defendant Belock. In due course the actions were consolidated and a "consolidated amended complaint" (the complaint) was filed on November 19, 1965.

The complaint bases jurisdiction on § 22(a)[1] of the Securities Act of 1933 (the 1933 Act), § 27[2] of the Securities Exchange Act of 1934 (the 1934 Act) "and the principles of pendent jurisdiction", as an action arising under §§ 12(2)[3] and 17(a)[4] of the 1933 Act and §§ 9(e),[5] 10(b)[6] and 18(a)[7] of the 1934 Act, "the General Rules and Regulations promulgated under both statutes; and under common-law principles".

The facts alleged are that plaintiff Volk and plaintiff Heit is each "a security holder of defendant Belock", Volk having purchased 100 shares of Belock's common stock on April 22, 1965 and another 100 shares of Belock's common stock on April 27, 1965, all at $5½ per share and Heit having purchased $5,000 face amount of Belock's 6% convertible subordinated debentures on June 18, 1965 at a price of 90% of the face amount.

Volk, although as aforesaid, she alleges that she acquired her stock on April 22 and April 27, 1965, sues on her own

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[1] 15 U.S.C. § 77v.

[2] 15 U.S.C. § 78aa.

[3] 15 U.S.C. § 77*l*.

[4] 15 U.S.C. § 77q.

[5] 15 U.S.C. § 78i(e).

[6] 15 U.S.C. § 78j(b).

[7] 15 U.S.C. § 78r(a).

behalf and on behalf of all other persons who purchased Belock's common stock between April 30, 1964 and June 21, 1965 and "who have either sold or continue to hold such stock at a loss" (the stock class).

Heit, although as aforesaid, he alleges that he acquired his debentures on June 18, 1965, sues on his own behalf and on behalf of all other persons who purchased Belock's debentures between April 30, 1964 and June 21, 1965 and "who have either sold or continue to hold such debentures at a loss" (the debenture class).

It is further alleged that defendants Weitzen, Tyminski, Fischer, Grant and Silverstein constituted, during the times mentioned, all or a majority of Belock's board of directors and that at all such times defendant Tyminski was Belock's president, defendant Silverstein was Belock's vice president and controller and defendant Fischer was Belock's secretary, and that Tyminski's and Silverstein's tenure terminated on August 18, 1965 by their removal as officers of Belock at which time defendant Levy was also removed as a vice president of Belock to which office he had been elected in the summer or fall of 1964.

The complaint then avers that defendant Belock, which manufactures and sells precision and other instruments and components, is a New York corporation, with its principal office in Queens County, New York; that at all the times mentioned its common stock was and now is listed on the American Stock Exchange (ASE); that since February 11, 1963 its debentures (Series A) were and now are listed on said Exchange and from January 23, 1963 to June 21, 1965 its debentures (Series B) were traded on the over-the-counter market.

The complaint then charges that on or about February 4, 1965 defendant Belock, at the direction of the individual

defendants, caused to be filed with the Securities and Exchange Commission (SEC) pursuant to the provisions of the 1934 Act and the General Rules and Regulations promulgated thereunder and with the ASE its annual report for the fiscal year ending October 31, 1964 and thereafter caused copies of said annual report to be sent to its security holders, the press, brokers and dealers, research organizations and financial institutions.

It is further charged by plaintiffs that the said annual report

> "contained statements which were materially false and misleading and contained untrue statements of material facts in that they substantially overstated Belock's net assets and past and prospective income"

because *inter alia*

> "such statements of assets and income were based in large part upon the inclusion therein of earnings, income and assets resulting from substantial overcharges to the United States Government in connection with contracts between Belock and the Government."

It is also alleged that similar materially false, misleading and untrue statements of Belock's net assets and past and prospective income were contained in reports and other documents filed by Belock at the direction of the individual defendants with the SEC and the ASE for the quarters ending April 30, July 31 and October 31, 1964, for the half year ending October 31, 1964 and for the quarter ending January 31, 1965 and that these were released to the press and to the stockholders.

The complaint further charges that the individual defendants "had knowledge or notice" that the said reports,

statements and documents "were false, misleading and contained untrue statements of material facts" and that the dissemination thereof was "intended to, and did, have the effect of artificially inflating the market prices of Belock's" securities.

After alleging that the offending data were distributed in interstate commerce, etc., the complaint charges that

> "As a result of the defendants' acts * * * Belock's common stock and debentures were sold to and bought by plaintiffs and the other members of the stock class and the debenture class at artificially inflated prices substantially in excess of their value, and such value has since been further reduced on account of such acts."

Claiming that they and the other members of the two classes purchased and retained Belock's securities in reliance on the truth of the statements and representations alleged, plaintiffs aver that they thereby "sustained substantial damages".

Asserting that plaintiffs and the other members of the two classes did not, and could not by the exercise of reasonable diligence, discover the facts alleged more than a few days prior to the institution of "these actions" and the reasons for the class actions, the plaintiffs then demand judgment for damages and the expenses of the litigation.

The sufficiency of the complaint is now challenged by four motions:—One, by defendant Tyminski, pursuant to F.R. Civ.P. 12(b) (6) to dismiss the complaint for failure to state a claim upon which relief can be granted and the remaining three by defendant Grant and defendant Belock separately and defendants Weitzen and Fischer jointly, seeking relief similar to that sought by Tyminski but in

addition and alternatively, under F.R.Civ.P. 56, summary judgments in favor of said defendants upon the grounds that since plaintiffs purchased their securities at the prices stated, Belock's common stock and debentures have sold at prices in excess of that paid by each plaintiff and that plaintiffs have therefore suffered no damage.

In their memorandum in opposition to the four motions, plaintiffs make no mention of their allegations in their complaint that their suit is based on §§ 12(2) and 17(a) of the 1933 Act and § 9(e) of the 1934 Act, and, despite the arguments of defendants *inter alia* in their memoranda that those sections of the acts supply no basis for this suit, plaintiffs address themselves solely to their right to sue under §§ 10(b) and 18(a) of the 1934 Act. Since the compelling reasons stated by defendants in challenging plaintiffs' right to sue under §§ 12(2) and 17(a) of the 1933 Act and § 9(e) of the 1934 Act, are ignored by plaintiffs, it is assumed that plaintiffs have abandoned those claims.

It should be remembered that we are not dealing here with the enormity of the fraud alleged but simply with the question of whether plaintiffs' complaint states a claim for which redress may be had in a federal court under the federal statutes and rules relied upon.

The 1934 Act provides in § 10(b):

> "REGULATION OF THE USE OF MANIPULATIVE AND DECEPTIVE DEVICES
>
> Sec. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> • • • • • —•

(b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b–5[8] promulgated by the SEC pursuant to § 10(b) supra reads:

"Rule 10b–5. Employment of Manipulative and Deceptive Devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) to employ any device, scheme or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

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[8] 17 CFR § 240.10b–5.

The complaint alleges as operative facts simply that certain of Belock's quarterly, semi-annual and annual reports filed with the SEC and the ASE and otherwise disseminated overstated Belock's net assets and past and prospective income because they omitted disclosure that these included the product of substantial recoverable overcharges by Belock to the Government on contracts between them.

Accepting this statement as true for the purposes of this motion under F.R.Civ.P. 12(b) (6), the defendants did therefore at least "omit to state a material fact necessary in order to make the statements made * * * not misleading" which Rule 10b–5(b) proscribes. However, to be unlawful and actionable, the forbidden act or omission must, under both the statute and the rule, occur "in connection with the purchase or sale of any security".

While the complaint charges that the individual defendants "had knowledge or notice" of the misleading reports, which "artificially inflated the market prices of Belock's common stock and debentures" causing plaintiffs and the members of the two classes, relying on the statements, to purchase Belock's securities "at artificially inflated prices substantially in excess of their value" it is devoid of the statement of any facts that the fraud complained of was perpetrated by the defendants "in connection with any purchase or sale" of Belock's stock or debentures.

The fraud against the Government in overcharging it on the contract having been already accomplished, the concealment thereof from the filed statements was for the purpose of further defrauding the Government by not disclosing the original malfeasance and not for the purpose of perpetrating a "misrepresentation or fraudulent practice usually associated with the sale or purchase of securi-

ties". Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir. 1952), cert. denied, 343 U.S. 956, 72 S.Ct. 1051, 96 L.Ed. 1356 (1952).

On the same operative facts as are presented here, Judge Cooper, in Howard v. Levine, D.C., 262 F.Supp. 643, dismissed the complaint in that action upon the grounds that

> "The instant complaint is fatally defective for the allegations here do not show the gravamen of defendants' activities to be any wise 'in connection with the purchase or sale of any security' as those words have been construed in their statutory setting. Whatever fraud is alleged here (it is in bare skeletal form) is directed against the government, notwithstanding its possible incidental market impact. Furthermore, defendants or persons associated with them did not participate in the security transactions involved. Joseph v. Farnsworth Radio & Television Corp., 99 F.Supp. 701 (S.D.N.Y.1951), aff'd per curiam, 198 F.2d 883 (2d Cir. 1952). Cf. Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); H. L. Green Co., Inc. v. Childree, 185 F.Supp. 95 (S.D.N.Y.1960). * * * "

Plaintiffs' attempt to distinguish the *Howard* complaint from this one because the former merely alleged circulation and dissemination of the offensive statements whereas the latter also alleges filing thereof with the SEC and the ASE, in so far as the § 10(b) and Rule 10b–5 aspect of the case are concerned, is an unimpressive and unpersuasive distinction without a difference.

The *Howard* complaint, *inter alia*, disclosed:

> "The statements * * * were examined or certified, or both, by * * * Lybrand, Ross, [defendant-accountant

firm] which knew or should have known that such * * * were incorrect and false and misleading.

* * * The publication and dissemination of the material alleged * * * served to raise or prevent the market prices from declining of the securities of Belock * * * as the defendants well knew and intended and the defendants [named] benefited therefrom.

* * * The * * * statements * * * were circulated * * * to influence and manipulate the prices of securities of Belock * * * and constituted the employment * * * of a device, scheme or artifice to defraud * * * which operated as a fraud or deceit upon plaintiff and all others similarly situated.

* * * The defendants had or were charged with knowledge of the facts alleged * * * *"*

As to those allegations in the *Howard* complaint Judge Cooper held:

"In addition, the allegations of fraud are legally insufficient even under a liberal construction of the pleadings afforded to plaintiffs on a motion to dismiss. O'Neill v. Maytag, 230 F.Supp. 235, 239 (S.D.N.Y.) aff'd., 339 F.2d 764 (2d Cir. 1964); Weber v. C.M.P. Corp., 242 F.Supp. 321 (S.D.N.Y.1965). * * * *"*

In the complaint here under consideration no more is alleged for all that is stated is that

"The individual defendants had knowledge or notice that the reports, statements and documents * * * were false, misleading and contained untrue statements of material facts * * * [and that] The dissemination of the statements * * * was intended to, and did, have

the effect of artificially inflating the market prices of Belock's common stock and debentures."

The complaint herein, to the extent that it purports to state a claim for relief under § 10(b) of the 1934 Act and Rule 10b–5 of the SEC is vulnerable.

As aforesaid, the complaint also states that the claims asserted therein arise under § 18(a) of the 1934 Act. In this regard it differs from the complaint in the *Howard* case which made no such claim.

Section 18(a) of the 1934 Act provides:

"LIABILITY FOR MISLEADING STATEMENTS

Sec. 18. (a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an

undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant."

It is obvious that for the plaintiffs to prevail under this section it must appear that the reports which they claim failed to disclose the fraud against the Government were such as were "filed pursuant to this title or any rule or regulation thereunder". Regardless of what meaning the verb "filed" may have in any other context, cf. 36A C.J.S. p. 395, it has a very limited meaning under § 18(a) of the 1934 Act with respect to reports such as those here involved.

The only pertinent reports required by the statute are those mandated by § 13(a) (2)* of the 1934 Act, which provides:

"Sec. 13. Periodical and other reports

(a) Every issuer of a security registered pursuant to section 12 of this title shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security—

* * * * * *

(2) such annual reports (and such copies thereof), certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports (and such copies thereof), as the Commission may prescribe."

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* 15 U.S.C. § 78m.

Under § 13(a) (2) of the 1934 Act the SEC was vested with the power to require that annual reports be certified by independent public accountants and to require the filing of quarterly reports. It has exercised those powers with respect to companies such as defendant Belock only to the extent of requiring annual and semi-annual reports.[10] The annual reports are those filed on Form 10–K and the semi-annual reports are those filed on Form 9–K. The Commission's rules governing these reports in pertinent part are as follows:

(As to annual reports—Form 10–K):
"17 CFR

Annual Reports

§ 240.13a–1 Requirement of annual reports.

Every issuer having securities listed and registered on a national securities exchange shall file an annual report for each fiscal year after the last full fiscal year for which financial statements were filed in its application for registration. • • •

§ 249.310 Form 10–K, annual report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934.

• • • • • •

(b) General instructions—(1) *Rule as to use of Form 10–K.* Form 10–K shall be used for annual reports pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934, for which no other form is prescribed.

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[10] Quarterly reports are required to be filed by investment companies, 17 CFR § 240.13a–12, and by certain real estate companies, 17 CFR § 240.13a–15.

(o) *Annual reports and proxy material sent to stockholders.* (i) Every registrant which files an annual report on this form shall furnish to the Commission for its information four copies of the following • • •

(a) Any annual report to stockholders covering the registrant's last fiscal year • • •

Such material shall be mailed to the Commission not later than the date on which it is first sent to stockholders • • •

(ii) The foregoing material shall not be deemed to be 'filed' with the Commission or otherwise subject to the liabilities of section 18 of the Act • • • "

(As to semi-annual reports—Form 9–K):

"17 CFR § 240.13a–13 Semi-annual reports on Form 9–K.

(a) Every issuer of a security registered on a national securities exchange which is required to file annual reports on Form 10–K • • • shall file a semi-annual report on Form 9–K • • •

• • • • • •

(d) Notwithstanding the foregoing paragraphs of this section, reports pursuant to this section on Form 9–K shall not be deemed to be 'filed' for the purpose of section 18 of the act or otherwise subject to the liabilities of that section • • • "

From the foregoing rules it is quite clear that none of the reports upon which the plaintiffs' claims are predicated were "filed" with the Commission as required by § 18(a) of the 1934 Act.

It follows, therefore, that the complaint herein to the extent that it purports to state a claim for relief under § 18(a) of the 1934 Act is also vulnerable.

Thus, since the complaint fails to state a federal claim upon which relief can be granted, there is no pendent jurisdiction of the state claims surviving and as Judge Cooper observed in the *Howard* case

> "• • • there being no diversity jurisdiction alleged, any causes of action recognized under state law as set forth in the complaint should also be dismissed. Ruckle v. Roto American Corp., 339 F.2d 24, 27 (2d Cir. 1964) • • •"

In the light of the conclusion that the defendants' motions to dismiss the complaint must prevail, the additional and alternative motions of some of the defendants for summary judgment are not passed upon.

The motions by defendants Tyminski, Grant and Belock severally and of the defendants Weitzen and Fischer jointly to dismiss the complaint herein pursuant to F.R.Civ.P. 12(b) (6) are granted without leave to plead anew.

It is so ordered. No further order is necessary.

APPENDIX "C"

UNITED STATES DISTRICT COURT

FOR THE SOUTHERN DISTRICT OF NEW YORK

No. 65 Civ. 2148

November 24, 1965

HELEN HOWARD,

Plaintiff,

—against—

LAWRENCE J. LEVINE, JACK SILVERSTEIN, STANLEY R. GRANT, WALTER V. TYMINSKI, EDWARD H. WEITZEN, JOHN F. DONATO, JACK J. FISCHER, CARL M. LOEB, RHOADES & Co., a partnership, LYBRAND, ROSS BROS. & MONTGOMERY, a partnership, and JACK J. FISCHER, CHARLES WELTHY and HARRY AHRENS, as Executors of the Estate of HELEN NEUSCHAFER, DECEASED and BELOCK INSTRUMENT CORPORATION,

Defendants.

COOPER, District Judge.

These are motions to dismiss a complaint under Rule 12(b) (6), F.R.Civ.P. for failure to state a claim upon which relief can be granted.

The complaint is apparently predicated on Section 10(b) of the Securities Act of 1934, 15 U.S.C. § 78j(b) and Rule 10B–5, 17 C.F.R. 240.10b–5, the jurisdiction of the Court

being invoked under 15 U.S.C. § 78aa.[1] In essence, the complaint alleges that Loeb, Rhoades & Co., Belock Instrument and the individual defendants have caused to be circulated and disseminated to the public-at-large financial statements which were gross overstatements because they failed to reflect improper distribution of costs and overcharges in certain government contracts; this dissemination served to raise the market price of Belock Instrument, and the defendants "benefited therefrom."

Rule 10B–5 requires that the alleged fraud or deceit be "in connection with the purchase or sale of any security." As the Court said in Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir. 1952), "that section [10b] was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs * * *." O'Neill v. Maytag, 339 F.2d 764, 768 (2d Cir. 1964).

The instant complaint is fatally defective for the allegations here do not show the gravamen of defendants' activities to be any wise "in connection with the purchase or sale of any security" as those words have been construed in their statutory setting. Whatever fraud is alleged here (it is in bare skeletal form) is directed against the government, notwithstanding its possible incidental market impact. Furthermore, defendants or persons associated with them did not participate in the security transactions involved. Joseph v. Farnsworth Radio & Television Corp., 99 F.Supp. 701 (S.D.N.Y.1951), aff'd per curiam, 198 F.2d

[1] In oral argument and their briefs, the parties do not rely upon the Securities Act of 1933, as amended. 15 U.S.C. § 77a et seq., (see ¶ 1 of the complaint). As we see it, consideration of that Act does not alter the conclusion here reached.

883 (2d Cir. 1952). Cf. Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); H. L. Green Co., Inc. v. Childree, 185 F.Supp. 95 (S.D.N.Y.1960). In addition, the allegations of fraud are legally insufficient even under a liberal construction of the pleadings afforded to plaintiffs on a motion to dismiss.[2] O'Neill v. Maytag, 230 F.Supp. 235, 239 (S.D.N.Y.) aff'd, 339 F.2d 764 (2d Cir. 1964); Weber v. C. M. P. Corp., 242 F.Supp. 321 (S.D.N.Y.1965). Finally, there being no diversity jurisdiction alleged, any causes of action recognized under state law as set forth in the complaint should also be dismissed. Ruckle v. Roto American Corp., 339 F.2d 24, 27 (2d Cir. 1964).

Accordingly, the motions to dismiss are granted. We see no basis for permission to replead.

This shall be considered an order; settlement thereof is unnecessary.

So ordered.

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[2] In view of this analysis, the policy arguments and views advanced by plaintiffs at pages 8-9 and 19-20 of their Memorandum filed in Court on November 3, 1965 cannot provide a basis for sustaining their complaint.